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INCOME FROM CORPORATE DIVIDENDS

THOSE who worship the corporate entity as a real presence may confidently invite us all to marvel at the wonders wrought in its name. Those of a different faith who regard a corporation as nothing but a legal device whereby human beings may pool their activities and acquire peculiar legal privileges and duties must in their realism realize how very peculiar these peculiar privileges and duties may be. By and large the privileges attract more attention than the duties, but on the Ides of March the duties come into the limelight. Invisible and intangible the corporation may be, but it is readily seen and touched by those who gather in the revenues of government. The earnings of the enterprise render unto Cæsar through a tax on the corporation and again through a tax on the stockholder to whom the earnings are transmitted. Our national Cæsar is somewhat less grasping than he might be and so exempts corporate dividends from the eight per cent normal tax on individual income. He demands, however, an excess profits tax on the income of the corporation and a progressive surtax on such part of that income as passes on to stockholders fortunate enough to be subject to surtax. In assessing these two taxes no attention is paid to the actual situation of the actual investors who bear the burden.[1] In approving of this

[1] The excess profits tax imposes a progressive tax on corporate income in excess of the deduction of certain percentages of the invested capital of the corporation. In La Belle Iron Works *v.* United States, 256 U. S. —, 41 Sup. Ct. 528 (1921), invested capital is held to be the capital actually invested in the property of the corporation to the exclusion of appreciation subsequent to the acquisition of that

neglect the Supreme Court reveals the miraculous properties of incorporation.

With taxes on the corporation this paper is not concerned. Double taxation of corporation and of stockholder is important only because of resulting inequalities between different methods of doing business. These inequalities may perhaps be justified by the advantages accruing to those who become members one with another in a corporation. Clearly enough the income of the corporation should in some way be taxed as it is received. Otherwise the corporate treasury might be made a delectable place of refuge for stockholders who can afford to leave that treasury intact. Clearly enough, too, a progressive tax on individual recipients of income ought not to spare individual gains that are the fruit of business conducted in corporate form. Unless the individual is subjected to this progressive tax as his gains accrue to the corporation, he should meet it when his gains come to him by way of corporate dividends. The latter alternative is the one adopted by Congress and perhaps the only one that the Supreme Court would permit it to adopt.[2] But the gains thus treated as income to the stockholder need not be gains to him. It is enough if they are gains to the corporation, and are then transferred from the corporation to the stockholder. Thus we have an anomalous conception of income from property which dispenses with any requisite of gain.

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property. No account is taken of the amounts paid by existing stockholders for their interest in the corporation. Thus corporate income, which is at a high rate of return on the investment of the corporation, may bring but a moderate rate of return on the investment of stockholders who paid a high price for their stock. The tax therefore imposes unequal burdens on the amounts invested by those who acquired their stock prior to its imposition. Subsequent purchasers would of course take into consideration the reduction of the corporate net income occasioned by the tax.

[2] In Collector *v.* Hubbard, 12 Wall. (U. S.) 1 (1870), the Supreme Court sustained a federal tax on stockholders for their proportionate shares of the income received by the corporation, this income not being taxed to the corporation itself. In "The Stock Dividend Decision and the Corporate Nonentity," 5 BULLETIN OF THE NATIONAL TAX ASSOCIATION, 201, I have tried to make out that this decision can still stand notwithstanding the aspersions cast upon it in Mr. Justice Pitney's opinion in Eisner *v.* Macomber, 252 U. S. 189, 217–219 (1920). Mr. Arthur Ballantine, whose judgment is more valuable and more expensive than mine, thinks that these aspersions indicate that "the method sustained by the court in the Hubbard case would not be sustained to-day, at least in the case of large and active business corporations employing large capital." See his "Corporate Personality in Income Taxation," 34 HARV. L. REV. 573, 586.

The anomaly seems the more anomalous when we recall that the Supreme Court declares that in deciding whether what Congress chooses to call income is income within the meaning of the Sixteenth Amendment, "it becomes essential to distinguish between what is and what is not 'income,' as the term is there used; and to apply the distinction, as cases arise, according to truth and substance, without regard to form."[3] This authoritative recognition of the superiority of truth and substance on the one hand to form on the other is sufficient warrant for an effort to apply the tests of truth and substance to the interpretations of the Sixteenth Amendment which the Supreme Court has given us. Two principal issues are presented: How can truth and substance permit the discovery of income from property where there is no gain therefrom? To what extent are the judicial distinctions between dividends held income and dividends held not income the product of truth and substance and to what extent the product of form?

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That the process of issuing and receiving a dividend need not be in itself gainful in order to make the dividend income to its recipient is too plain to admit of criticism. Otherwise no dividend would be income, since the stockholder's interest in the corporation is necessarily reduced in value by the amount which the corporation turns over to him; his left hand loses what his right hand gains. Similarly the receipt of salary or of the price for the sale of property is not in itself normally a gainful process. One's credit at the bank may be as good when his salary is collectible as when it is collected. An owner of what we may call a $10,000 house is as rich with the house as with the $10,000 which he gets for selling it. The question in such a case is not whether the transaction is itself gainful but whether it yields a gain as of the appropriate antecedent date.[4] If the house was bought for $5,000, its

[3] Mr. Justice Pitney, in Eisner *v.* Macomber, 252 U. S. 189, 206 (1920).

[4] Confusion on this point is contributed by inferences drawn from Mr. Justice Holmes's statement in Towne *v.* Eisner, 245 U. S. 418, 426 (1918), that after a stock dividend "the corporation is no poorer and the stockholder is no richer than they were before." Since shortly after this, dividends in cash and in the stock of another corporation were held in Lynch *v.* Hornby, 247 U. S. 339 (1918), and Peabody *v.* Eisner, 247 U. S. 347 (1918), to be income to the stockholder though they made him no richer than he was before, it was clear enough from then on that dividends which

sale for $10,000 turns a $5,000 gain from an interest in a house to cash in hand. The gain that was not income so long as it still inhered in the capital becomes income when extracted from it.[5] To get income from the sale of property both gain and its extraction are required.[6] To get income from corporate dividends, ex-

make the corporation poorer are income to the stockholder though they make him no richer, and that the *dictum* of Mr. Justice Holmes was directed to the point that unless the corporation parts with some of its assets which the stockholder receives there is not a sufficient change in the nature of the stockholder's interest to satisfy the test of realization which is made one of the requisites of income, *i. e.*, that without "outcome" from the corporation there cannot be "income" to the stockholder. *Cf.* Mr. Justice Pitney's statement in Peabody *v.* Eisner, at page 349, that the ground of Towne *v.* Eisner was that "it related to a stock dividend which in fact took nothing from the property of the corporation and added nothing to the interest of the shareholder, but merely changed the evidence which represented that interest," and his statement in Eisner *v.* Macomber, 252 U. S. 189, 211 (1920), that "the essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit."

[5] Profit from the sale of capital was held income in Merchants' Loan & Trust Co. *v.* Smietanka, 255 U. S. 509 (1921); Eldorado Coal & Mining Co. *v.* Mager, 255 U. S. 522 (1921); Goodrich *v.* Edwards, 255 U. S. 527 (1921); and Walsh *v.* Brewster 255 U. S. 536 (1921).

[6] That the requisite extraction is wrought by the sale is held in the cases cited in note 5, *supra.* In the first of these cases Mr. Justice Clarke quotes a previously approved definition of income as "a gain derived from capital, from labor, or from both combined," and adds:

". . .we continue entirely satisfied with that definition, and, since the fund here taxed was the amount realized from the sale of the stock in 1917, less the capital investment as determined by the trustee as of March 1, 1913, it is palpable that it was a 'gain or profit' 'produced by' or 'derived from' that investment, and that it 'proceeded' and was 'severed' or rendered severable, from it, by the sale for cash, and thereby became that 'realized gain' which has been repeatedly declared to be taxable income within the meaning of the constitutional amendment and the acts of Congress. *Doyle* v. *Mitchell Brothers Co.*, and *Eisner* v. *Macomber*, supra." (255 U. S. 509, 519–520.)

As to the general rule that gain is a requisite of income from the sale of property there is no doubt, even though the point may not have been explicitly adjudicated under the Sixteenth Amendment. The fact that the approved definition of income starts with "gain" would not be controlling, since dividends from corporate stock are brought within the definition without inquiry into the gain involved. But in construing the Federal Corporation Excise Tax of August 5, 1909, Mr. Justice Pitney, in Doyle *v.* Mitchell Brothers Co., 247 U. S. 179, 185 (1918), said of the definition quoted above:

"Understanding the term in this natural and obvious sense, it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many if not in most cases there results a gain that properly may be accounted as a part of the 'gross income' received 'from all sources'; and by applying to this the authorized deductions we

traction alone satisfies the Supreme Court. What is extracted by the dividend is held to be income even though after the dividend the recipient is no richer than when he acquired the stock on which the dividend is paid.

The case in which this first appears is *Lynch* v. *Hornby*,[7] decided in 1918. This involved a cash dividend paid in 1914 from the proceeds of the sale of property which the corporation had owned prior to 1913 when the Sixteenth Amendment took effect. While in the particular case the stockholder had owned his stock from 1906 and the dividend doubtless represented a gain to him as from that time, the decision goes on grounds broad enough to sustain the tax on one who had bought his stock shortly before the dividend was declared at a price based on the existence of the melon ready for cutting.[8] Thus it would justify treating as income a dividend of $100 paid to a stockholder who had a month before paid

arrive at 'net income.' In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration."

In Merchants' Loan & Trust Co. *v.* Smietanka, note 5, *supra*, Mr. Justice Clarke declared that the use made of the definition of income in the decision of cases under the Corporation Excise Tax Act was decisive of the case then before the court. The particular opinion in which this observation was made had to do only with the issue whether actual profit from the sale of property is income, but in two other cases decided at the same time there was the issue whether under the Income Tax Act of 1913 Congress meant to treat as income whatever realization on the sale of property was in excess of its value on March 1, 1913, even though its value on that date was less than the cost of the property when acquired. In holding that the income taxable under the Act is confined to the excess of sale price over cost price, the court must have been influenced more by its judgment that the taxable income should be restricted to the actual gain than by the language of the statute. This interpretation is set forth in note 9, *infra*. An explicit decision that Congress cannot discover income from the sale of property except to the extent of the gain as from the appropriate past date, has thus far been rendered unnecessary by the ability to hold that Congress has not sought to do so. An exception to this appears in Stanton *v.* Baltic Mining Co., 240 U. S. 103 (1916), in which Congress was allowed to limit the allowance for depletion of the mine in reckoning the income from the sale of ore. For consideration of this see "Constitutional Aspects of Federal Income Taxation" in THE FEDERAL INCOME TAX (Columbia University Press, 1921), pp. 66–68.

[7] 247 U. S. 339 (1918).

[8] This is true also of Peabody *v.* Eisner, 247 U. S. 347 (1918), decided on the same day. The dividend involved here was paid by one corporation in the stock of another corporation. Nothing is said as to the time when the recipient acquired his parent stock except that it was prior to March 1, 1913. The dividend was received in 1914.

$200 for his share of stock which the payment of the dividend reduced to its par value of $100. With the issue whether this was within the intention of Congress [9] or the issue whether dividends which are the fruit of corporate assets possessed prior to the Sixteenth Amendment may be taxed as income when paid after that Amendment [10] we are not primarily concerned. Both questions

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[9] On this point Mr. Justice Pitney said, in Lynch *v.* Hornby:

"Hence we construe the provision of the act that 'the net income of a taxable person shall include gains, profits, and income derived from . . . interest, rent, dividends,' . . . as including (for the purposes of the additional tax) all dividends. . . . In short, the word 'dividends' was employed in the act as descriptive of one kind of gain to the individual stockholder; dividends being treated as the tangible and recurrent returns upon his stock, analogous to the interest and rent received upon other forms of invested capital." (247 U. S. 339, 344–345.)

Compare with this the interpretation of the Income Tax Act of 1916 in Goodrich *v.* Edwards, note 5 *supra*, to limit the taxable income from the sale of property to the actual gain. The statute provided explicitly that for the purpose of ascertaining the gain derived from the sale of property acquired before March 1, 1913, the fair market price or value of the property as of that date "shall be the basis for determining the amount of such gain derived." The apparently unrestricted purport of these words was disregarded by the court by recurring to the general reference in the act to "gains, profits and income" and to the definition of income approved by the court and by declaring that "it is thus very plain that the statute imposes the income tax on the proceeds of personal property to the extent only that gains are derived therefrom by the vendor" and that the explicit provision making March 1, 1913, the upset date, so-called, "is applicable only where a gain over the original capital investment has been realized after March 1, 1913, from a sale or other disposition of property." Thus the only effect given to the specific clause making March 1, 1913, the "upset date" is to exclude gain accrued prior to that date. Such gain had been excluded by the Supreme Court in Lynch *v.* Turrish, note 10, *infra*, without any explicit direction in the Act of 1913. The explicit reference to March 1, 1913, in the Act of 1916 was therefore superfluous unless it was introduced to exclude loss accrued but unrealized prior to that date. It is difficult to believe that by denying it this effect the Supreme Court accurately surmised the intention of Congress.

[10] On this point Mr. Justice Pitney observed, in Lynch *v.* Hornby:

"That the retroactivity of the act from the date of its passage (October 3, 1913) to a date not prior to the adoption of the Amendment was permissible is settled by *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1, 20. And we deem it equally clear that Congress was at liberty under the Amendment to tax as income, without apportionment, everything that became income, in the ordinary sense of the word, after the adoption of the Amendment, including dividends received in the ordinary course by a stockholder from a corporation, even though they were extraordinary in amount and might appear upon analysis to be a mere realization in possession of an inchoate and contingent interest that the stockholder had in a surplus of corporate assets previously existing. . . . The stockholder is, in the ordinary case, a different entity from the corporation, and Congress was at liberty to treat the dividends as coming to him *ab extra*, and as constituting a part of his income when they came to hand." (247 U. S. 339, 343–344.)

were answered in the affirmative. Congress has relented with regard to dividends produced by corporate assets accumulated prior to 1913,[11] but it has left unchanged the provision which the Supreme Court interpreted as declaring dividends to be income to their full value even though what they bring to the stockholder is not to him a gain as from the time when he bought his stock.[12]

When we look to Mr. Justice Pitney's opinion for the truth and substance which justifies a conception of income without gain, we find statements that can hardly bear the strain of analysis. Dividends, he tells us, are commonly expended by the stockholder as income without regard to whether they come (1) from recent earnings or (2) from a surplus accumulated (a) from past earnings or (b) from an enhancement in the value of the corporate property.[13] To this he adds that dividends prove the capacity of the corporation to pay them, give hope of more dividends in the future, and quite probably increase the market value of the shares.[14] Neither

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On this question of gain accrued prior to the Amendment but realized thereafter, we find a contrast between corporate dividends and proceeds from the sale of property. Lynch *v.* Turrish, 247 U. S. 221 (1918), held that no part of the proceeds of the surrender of stock for a proportionate share of the corporate assets was taxable income within the meaning of the Income Tax Act of 1913, when the amount received on the dissolution of the corporation was not in excess of the value of the stock on the effective date of the Sixteenth Amendment.

[11] The provisions in the Acts of September 8, 1916, and October 3, 1917, are quoted in Mr. Justice Pitney's opinion in Lynch *v.* Hornby, and held not to be declaratory of the meaning of the Act of 1913, but a change of that meaning as a concession to the equity of stockholders. This concession is continued in section 201 of the Income Tax Act of 1921.

[12] Section 213 of the Income Tax Act of 1921 declares that gross income "includes gains, profits and income derived from . . . interest, rent, dividends, securities, . . . or gains or profits and income derived from any source whatever," with no provision to exclude dividends or any part thereof not bringing gain.

[13] The sentence in which these observations occur is in the paragraph quoted in note 10, *supra*, and apparently, therefore, is directed to the point that it is immaterial that a dividend brings no gain accruing subsequent to the effective date of the Sixteenth Amendment.

[14] The full statement on this point reads as follows:

"We do not overlook the fact that every dividend distribution diminishes by just so much the assets of the corporation, and in a theoretical sense reduces the intrinsic value of the stock. But, at the same time, it demonstrates the capacity of the corporation to pay dividends, holds out a promise of further dividends in the future, and quite probably increases the market value of the shares. In our opinion Congress laid hold of dividends paid in the ordinary course as *de facto* income of the stockholder, without regard to the ultimate effect upon the corporation resulting from their payment." (247 U. S. 339, 346.) This seems to be intended as a justi-

of these justifications touches the issue whether what the stockholder receives is for him a gain.[15] If it is not a gain, the stockholder who expends it as income is depleting his capital. His spending may not be influenced by the nature of the corporate activities which yielded the dividend, but unless he is a prodigal it certainly is influenced by the question whether those activities occurred before or after the date on which he bought his stock. He does not commonly expend as income such dividends as are nothing but a conversion of what he parted with his capital to get. Equally unsatisfactory is the assumption that the dividend increases the value of the stock. It certainly cannot help when it is false, and it is pretty plainly false when the dividend is the fruit of such a sale of corporate assets as that in the case at bar.

Somewhat more specific consideration of the miracle of income without gain appears in *United States* v. *Phellis*,[16] decided on November 21, 1921. Here a New Jersey corporation transferred all its assets to a Delaware corporation newly created for the purpose. The New Jersey corporation remained in existence and received stock of the Delaware corporation, of which it retained part in its treasury and distributed the rest among its stockholders. These stockholders were held to receive taxable income to the full value of the shares thus acquired, without inquiry into their actual gain from the time of their purchase of the parent stock. The objection that the rearrangement of their stockholdings was not in itself productive of gain was again made and readily dismissed as the "normal and necessary effect of all dividend distributions."[17] With this there can be no quarrel. Mr. Justice Pitney is less happy when he considers the possibility that the stockholders are taxed

fication only for the point that the fact that the issue and receipt of a dividend is not in itself a gain-producing transaction does not prevent the dividend from being income within the intention of Congress.

[15] See notes 13 and 14, *supra*, for the recognition that Mr. Justice Pitney was not directing his argument to the justification of treating dividends as income beyond the extent to which they bring a gain. In neglecting this issue he was warranted by the fact that the complaining stockholder had owned his stock since 1906 and for all that appears the corporate gain which made the dividend possible had all accrued while he was a stockholder. What he says, however, would, if always true, minimize the importance of inquiring whether a dividend brings a gain to the recipient, and its bearing on the question of gain is therefore material to the present inquiry.

[16] 257 U. S. —, 42 Sup. Ct. 63 (1921).

[17] 42 Sup. Ct. 63, 66 (1921).

on what is not a gain to them from any standpoint. It is easier to approve of his ideal in recognizing "the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder,"[18] than to commend his arguments that this ideal is realized in the opinion rendered.

Though the taxpayer is left without relief, he is given the consolation of sympathy, or perhaps only of "apparent" sympathy. He may be glad to be told that "the possibility of occasional instances of apparent hardship in the incidence of the tax may be conceded."[19] This apparent hardship intrudes when an investor buys shortly before the dividend at a price enhanced by an estimate of the corporate surplus which makes the dividend possible. Then if the surplus is distributed by a dividend, "with corresponding reduction in the intrinsic market value of the shares," and the stockholder is "called upon to pay a tax upon the dividend received, it might look in his case like a tax upon his capital."[20] Then follows the reassurance: "But it is only apparently so."[21] This is predicated on the analysis that in the purchase of shares in a corporation with a surplus pregnant with possible dividends, "presumably the prospect of a dividend influenced the price paid, and was discounted by the prospect of an income tax to be paid thereon."[22] This, it is to be observed, assumes the certainty of a taxable dividend issuing from the corporate surplus. The presumption would have no validity in those cases in which the retention of the surplus was anticipated. Even when an approaching dividend is certain and known of all men, the income tax thereon will vary according to total taxable incomes of the several recipients in the particular year in which the dividend chances to be declared. Conceivably it might happen now and then that a purchaser of stock about to bear an extraordinary dividend will pay to the seller and to the government combined just what the seller would have succeeded in getting if the income tax on the dividend were confined to the actual gain realized by the recipient. That such hypothetical coincidence would be frequent is not to be credited. Mr. Justice Pitney's presumption invokes a prevision and a precision more

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[18] 42 Sup. Ct. 63, 65 (1921).
[19] *Ibid.*
[20] *Ibid.*
[21] *Ibid.*
[22] *Ibid.*

characteristic of abstract speculation than of actual business transactions.

If the Supreme Court were really persuaded that corporate dividends should be regarded as income only to the extent that they bring the recipient an enhancement of his original investment in the shares from which they issue, it is unthinkable that it would have shut the door to proof that such enhancement is less than the value of the dividend. No one who attaches importance to the particular facts of a particular transaction would foreclose inquiry into the facts and substitute the suggestion that corporate shares are probably increased in value by the subtraction from the corporation of accumulated assets which have contributed largely to that value, and the presumption that the purchase price of shares in a corporation with a surplus reflects a tax on a possible future distribution of that surplus with such precision that an ensuing distribution brings the purchaser no part of that purchase price but only a gain and profit in addition thereto. The moderate and qualified manner in which these suggestions were put forth indicates a want of any firm faith in their merits. They might plead to be passed over in silence were it not for the attendant professions of regard for truth and substance.

There is of course truth and substance in the analysis that a prospective tax on a prospective dividend will depress the price that otherwise would be paid for the stock from which the dividend is anticipated. This, however, is quite different from a presumption that "the prospect of a dividend" which may or may not materialize will be "discounted" by the prospect of varying and unpredictable rates of taxation on the dividends that may in the future be received by different taxpayers. Such discounting would be possible only if the statutory rates of taxation are to remain uniform from year to year world without end and if sales of stock are confined to purchasers who know what rate they will pay on the dividends received. We know in fact that the statutory rates are subject to the whimsicalities of politics and that the taxable income of an individual varies from year to year. All this uncertainty makes certain the want of that enduring inelasticity which is essential to the validity of Mr. Justice Pitney's presumption that the prospect of a dividend is "discounted" by the prospect of an income tax to be paid thereon. Necessarily his bread

of consolation is a stone to those whose dividends come from stock acquired prior to that assured prospect of a tax which he takes for granted as one of the justifications for defeating the hope that the tax might be escaped.

This economic speculation has already lured me beyond my depth, but an additional element tempts me still further. When the prior holder of stock sells at a price greater than what he paid to acquire it, he is subjected to an income tax on the resulting profit. If the prospect of a tax on a threatened dividend influences possible purchasers to offer less for the stock than they otherwise would, the prospect of a tax on the profit from the sale of the stock must influence present owners to hold their stock at a higher price than they would otherwise demand. If one tax pulls the price down, the other pushes it up.[23] If the deterrent effect of taxation

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[23] To illustrate. Suppose no income tax to be reckoned with and one who buys stock for $100 sells it for $500, making a profit of $400. The purchaser then receives a dividend of $400 and his stock falls in value to $100. The dividend brings him no profit. Now suppose that the prospective seller and buyer are each subject to surtaxes of 50% but that the sale was made and the dividend paid without taking the taxes into account. The seller yields to the government $200 of his profit and the buyer yields $200 of his capital. After this experience they begin to bargain for the sale and purchase of other stock which has also risen from 100 to 500 since the present holder acquired it. Suppose that assured dividends make the stock worth $500 to the holder provided the corporate surplus is prevented from disgorging a dividend. In anticipation of a dividend, however, a purchaser will pay only $300 to acquire the stock since the dividend will cost him $200 in taxes. The owner, however, will not sell for $300. True, a dividend of $400 will cost him $200 in taxes and reduce his capital to $300. But if he sells for $300, he realizes a profit of $200 and pays a tax of $100. Thus there would remain of his investment only $200, which is $100 less than what he would have if he retained his stock and pays a tax on his dividend. Thus on our assumptions of perfect knowledge and perfect calculation on the part of possible sellers and buyers certain to pay a fifty per cent tax on their realized income, there would be an *impasse*. In fact, of course, present holders and possible purchasers would pay varying rates of income tax. The poor could afford to take less for their stock and to pay more to acquire it than could the rich. Now and then an equilibrium would be discovered so that the prospect of the taxes on profit from sale and from dividends might come near enough being "discounted" to overlook slight discrepancies. While the poor we have always with us and in great abundance, it may be doubted whether they have enough stock to sell or enough means to buy stock so that this imaginary equilibrium would amount to much in practice. The assumption that present stockholders are always free to choose between retaining their stock or selling it frequently does not fit the facts. When their stock is pledged some one else decides whether it shall be sold and the price may be appreciably less than what an untrammeled owner would demand. To the extent that in fact stock will be sold for whatever it will bring, the prospect of a tax on a dividend may come

were allowed to get in its perfect work, it might well deter both sales and extraordinary dividends. The influence of a single tax on the realization of an actual gain is inevitable unless genuine income is to be exempted. For a second tax on a subsequent transfer of the same gain there is less to be said. If those in the market and those in the seats of corporate power know that stock in a corporation with an accumulated surplus will be held at a higher price than its earning power alone would command and that those who pay this price must face the possibility of a tax on the transfer of this surplus by an extraordinary dividend, the golden eggs from the corporate goose will become smaller and fewer. By abstracting the deterrent effect of taxation from other factors in the situation, we see that in the abstract few sales would be made. That sales and extraordinary dividends continue to occur must be due to these other factors which frustrate the speculative niceties of the presumed incidence of taxation. These niceties doubtless put salt on the tail of the trend of what will happen in the long run, but they fall far short of an accurate account of the past transactions involved in the cases that come before the courts.

We must therefore reject Mr. Justice Pitney's consolation that the prospect of a tax on a dividend being a tax on capital is only "apparent." There must be instances in which a dividend brings to its recipient something more than a gain to the capital invested in the stock. When this happens, rates based on conceptions of what it is expedient to extract from gains are applied to transfers of capital. The severity of this is apparent. In the case of a stock normally selling at par and paying six per cent dividends, a tax of two per cent on the capital takes as much from the taxpayer as a tax of thirty-three and one-third per cent on the income. In applying to transfers of capital income tax rates fixed on the general understanding that they take toll only from gains from capital, we get a burden on capital many times as great as that which

close to being discounted. This, however, does not annihilate the hardship of treating dividends as income beyond the extent of the gain which they bring to the recipient. It merely shifts the burden. The seller not only pays a tax on the profit actually realized but is deprived of additional profit that he would have commanded but for the purchaser's prospect of a tax on a return to him of part of his capital. *Quære*, whether these double taxes, one of which is not confined to gains and profits, may not cost taxpayers more than they yield the government in cases where an owner of stock is forced to sell it for what he can get.

the government professes or in general attempts to impose. The truth and substance of such a result will appear more readily if we assume that an owner of property worth $200,000 transfers the title to a trustee and a year later receives back from him the title to one-half of it. This re-transfer would not be thought of by any one as an income-producing transaction. It would not give rise to an income tax. If, however, this $200,000 worth of property is exchanged for corporate stock with a par value of 100, and a year later the corporation transfers one-half of its assets to its stockholders, a foolish virgin who chose to participate in this second enterprise rather than in the first may under existing federal law pay $65,000 to the government while her wiser sister would pay nothing.

Here is food for thought for those who cherish the fancy that a corporation is a person entirely distinct from those fleshly creatures who are its stockholders. Mr. Justice Pitney seems to credit the notion when he says in *Lynch* v. *Hornby* [24] that "the stockholder is, in the ordinary case, a different entity from the corporation, and Congress was at liberty to treat the dividends as coming to him *ab extra*, and as constituting a part of his income when they came to hand." [25] He applies it when he concludes in *United States* v. *Phellis* [26] that "in short, the question whether a dividend made out of company profits constitutes income of the stockholder is not affected by antecedent transfers of the stock from hand to hand." [27] Perhaps the notion is useful and perhaps the application of it to the income tax on dividends is necessary. I am told that advisers of the Treasury sought to find some way by which recipients of extraordinary dividends might be taxed on no more than the gains which the dividends bring to them, and that they gave it up in despair because of the practical difficulties involved in the computation. The same difficulties would seem to be presented when a recipient of a stock dividend later sells the stock thus received.[28] Some of them, at least, appear when there is a sale of a portion of stock bought at different times at varying prices.[29] One can appreciate, however, that these unavoidable difficulties

[24] Note 7, *supra*.

[25] 247 U. S. 339, 344 (1918).

[26] Note 16, *supra*.

[27] 42 Sup. Ct. 63, 66 (1921).

[28] See MONTGOMERY, INCOME TAX PROCEDURE, 1920, pp. 490–492.

[29] *Ibid.*, pp. 364–365.

may be so burdensome that officials will be reluctant to add to them when the Supreme Court does not insist upon it. There may be satisfactory reasons why the court should refrain from insisting upon it. These reasons may be based on the truth and substance underlying the conduct of corporate business and the transfers of corporate stock. Practical convenience may require that the kaleidoscopic shuffling of stockholders be disregarded, notwithstanding the occasional hardship that may be involved. There still remains, however, the anomaly of income without gain or profit as evidence of the magic that incorporation may work. To this may be added the sleight of hand by which a corporate reorganization puts stock into a hat and pulls out other stock so different that the Supreme Court cannot see the identity.

II

If no dividend were regarded as income beyond the extent to which it brings a gain to the recipient, the distinctions between dividends that are realizations of income and those that are not would be a matter of minor concern. Nothing in the nature of things makes separation from capital one of the requisites of income from capital. From a practical common-sense point of view there is something strange in the idea that a man may indefinitely grow richer without ever being subject to an income tax. Idle land may increase in value $10,000 a year because of realizable though unrealized increase in rent-producing capacity, yet under the realization requisite this land produces no income until it is sold. Then all the long-accruing gain becomes income for the year in which it is realized by sale and is subject to the same high surtax rates that would be applied to the same amount of annually recurring rent. The insistence that there is no income from capital prior to separation from capital may in practice work as much hardship on taxpayers as it prevents. Professor Haig has argued strongly for a broader conception of income which relaxes the test of realization or separation.[30] Mr. Eustace Seligman has pointed out the difficulties which the requirement of realization introduces.[31] Both

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[30] "The Concept of Income — Economic and Legal Aspects," in THE FEDERAL INCOME TAX (Columbia University Press, 1921), pp. 1–28.

[31] In "Implications and Effects of the Stock Dividend Decision," 21 COLUMBIA L. REV. 313–332. In so far as the difficulties suggested by Mr. Seligman are predi-

writers recognize that wisdom and justice may dictate that income taxes on various kinds of gains should be postponed until those gains are realized. Their objections are to the judicial insistence that prior to realization there is no income within the meaning of that term in the Sixteenth Amendment. But the Supreme Court has willed and disposed of the constitutional issue. Gain is not income in the constitutional sense until it is "derived" or "drawn from" that in which it has been inhering. The *Stock Dividend Decision* has been discussed so fully [32] that further comment would be superfluous. It is sufficient here to accept its conclusion as a datum and to proceed to consider the extent to which the applications of the test of realization are the product of truth and substance and the extent to which they are the product of form.

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cated on the assumption that the court holds that in order to have income, gain must result from the act of converting part or all of the principal, the difficulties vanish with the rejection of the unwarranted assumption. Other dangers foreseen by Mr. Seligman are also unreal. He suggests that the separation test precludes the imposition of an income tax on the recipient of gifts or inheritances or on profit realized by the sale of assets so received. Clearly any gift comes to a donee *ab extra* in a much truer sense than a cash dividend comes to a stockholder, as in Lynch *v.* Hornby, note 10, *supra*. A gift is neither the product of nor new evidence of a previously existing interest, as is a stock dividend. If the gift is not treated as income when received, the proceeds from its later sale may be treated as income under the decisions that a sale yields income to the extent that the price received exceeds the original cost to the seller. If the entire proceeds of the sale of property received by gift may be taxed as income, *a fortiori* the government may treat as income such part of the price as exceeds the value of the property when transferred by gift or such part as exceeds the original cost to the donor. The question whether the rental value of a house occupied by its owner may be taxed as income is more doubtful, but the Stock Dividend Decision is certainly not controlling against holding that use and occupancy is the equivalent of rent, as occupancy afforded by an employer is the equivalent of salary. Mr. Seligman is sound in his analysis that the separation test of the Stock Dividend Decision precludes the imposition of an income tax on dividends in preferred stock or in bonds of the declaring corporation or on the receipt of the right to subscribe for new shares and that it limits an income tax on the sale of such rights to the gain arising out of the entire transaction from the time of the purchase of the shares from which the rights issued.

[32] In addition to discussions cited elsewhere in this article see Charles E. Clark, "Eisner *v.* Macomber and Some Income Tax Problems," 29 YALE L. J. 735; Fred R Fairchild, "The Stock Dividend Decision," 5 BULLETIN OF THE NATIONAL TAX ASSOCIATION, 208; Thomas Reed Powell, "The Judicial Debate on the Taxability of Stock Dividends as Income," 5 BULLETIN OF THE NATIONAL TAX ASSOCIATION 247; and "Stock Dividends, Direct Taxes, and the Sixteenth Amendment," 20. COLUMBIA L. REV. 536; A. M. Sakolski, "Accounting Features of the Stock Dividend Decision," 5 BULLETIN OF THE NATIONAL TAX ASSOCIATION, 212; Edward H. Warren, "Taxability of Stock Dividends as Income," 33 HARV. L. REV. 885; and editorial

In his dissent in *Eisner* v. *Macomber*[33] Mr. Justice Brandeis adduces the substantial similarity between two ways of cutting corporate melons without decreasing the assets of the corporation. One is a cash dividend coupled with a preferential right to subscribe for new shares. The cash dividend is held taxable income, and the fact that the cash is used to buy new shares is not material. The other method combines these two transactions. The corporation keeps its assets instead of paying them out and getting them back again, but it gives to its stockholders additional stock to represent the former corporate surplus now transferred to capital. The stockholder who receives a stock dividend is in the same situation as one who uses a cash dividend to buy new shares. In all substance, therefore, urges Mr. Justice Brandeis, since the latter has received income, the former has also. It cannot matter, he adds, that the dividend is in stock and not in cash, since it is already established that income is derived by a dividend paid by one corporation in the stock of another. On the other hand, Mr. Justice Pitney for the majority adduces the substantial similarity between the state of the recipient of a stock dividend and that of the recipient of no dividend. Neither receives assets from the corporation. The interest of each is still represented by stock in the corporation. One receives an addition to the number of his shares and the other does not, but the value of the new shares lessens *pro tanto* the value of the old. Stock dividends necessitate an increase in the number of outstanding shares of the corporation so that the fractional interest of the stockholder remains the same whether he gets a stock dividend or no dividend. If, therefore, one who gets no dividend receives no income, one who gets a stock dividend receives no income. Mr. Justice Pitney's substantial similarity is as substantial as Mr. Justice Brandeis's substantial similarity. When they lead to opposite results, we are inclined to suspect some intrusion of form as a criterion of income or no income.

This inclination is even more pressing when we come to the cases in which corporations have paid dividends in the stock of other corporations or in which corporations have rearranged their financial relations with other corporations. The two classes of cases

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notes in 18 MICH. L. REV. 689, 4 MINN. L. REV. 462, 68 U. OF PENN. L. REV. 394, 6 VIRGINIA L. REG. (N. S.) 220, and 29 YALE L. J. 812.

[33] 252 U. S. 189 (1920).

present somewhat different problems, but the problems and their solution invite comparison. The first group of cases involves three parties; the second, only two. Both groups present the issue whether the relations between two corporations are such that they should be regarded as in substance identical. The issue in the second group of cases arose under the Act of 1913 by which intercorporate dividends were taxed as income of the receiving corporation. The taxation of such dividends was sustained in *Brushaber* v. *Union Pacific R. Co.*[34] as against the objection that it discriminated against corporations in favor of individuals when the latter did not have to include dividends in the assessment of the normal tax. No objection seems to have been made on the ground that the burden of all the taxes is borne by the stockholders of the corporation having the last place in the receiving line and that it is artificial in the extreme to treat every intercorporate payment as a distinct taxable gain. Congress, however, has recognized the force of this objection, and corporations are not now taxed on dividends received by them.[35]

When corporations were taxable on dividends, two corporations convinced the Supreme Court that what was in form a dividend was not one in substance and was therefore not within the intent of the term as used by Congress. In *Southern Pacific Co.* v. *Lowe*[36] the plaintiff corporation owned all the stock of the Central Pacific Railway Company and was the lessee and operator of all its property. The Central Pacific kept no bank account and all its funds were in possession of the Southern Pacific. Prior to 1913 the Central Pacific showed upon its books a surplus consisting chiefly of sums due from the Southern Pacific under the terms of the lease. In 1914 by bookkeeping entries the Southern Pacific acknowledged a dividend from the Central Pacific and the Central Pacific acknowledged payment by the Southern Pacific of its indebtedness. These bookkeeping entries were all that took place. The court held that the dividend was an appearance and not an actuality and that no taxable income was received thereby. The situation in *Gulf Oil Corporation* v. *Lewellyn*[37] was substantially similar except that the stockholding corporation did not manage the busi-

[34] 240 U. S. 1 (1916).
[35] See section 234 (a) (6) of the Acts of 1918 and of 1921.
[36] 247 U. S. 330 (1918).
[37] 248 U. S. 71 (1918).

ness or have possession of the property of its subsidiaries. The dividend here took place only through bookkeeping entries. The parent corporation had allowed its subsidiaries to keep their earnings and thereby to accumulate a surplus. Part of this surplus was embodied in debts due from some subsidiaries to others. The so-called dividend was a transfer of these debts by the creditor subsidiaries to the parent corporation. This too was held to be mere bookkeeping and not a realization of income.

Turning to the reasoning of the opinions we may dismiss the reliance in the *Southern Pacific* case on the fact that the parent had all the assets and managed all the business of its child, since the absence of such elements in the *Gulf Oil* case was dismissed as immaterial. We should too, it would seem, dismiss the fact that the gain of the subsidiaries accrued prior to the effective date of the Sixteenth Amendment, since genuine dividends paid to stockholders after the Amendment may be taxable income even though they are the fruit of corporate gains accrued prior to the Amendment.[38] Yet Mr. Justice Pitney in the *Southern Pacific* case lays stress on what he calls the evident purpose of Congress "to refrain from taxing income that accrued prior to March 1, 1913."[39] There is room for dispute as to what he means by this. Since gains and profits are not income until received or realized, it is confusing to speak of "income accrued." If it means gain accrued but not realized, it is incorrect to call it income. If it means "income received," it is safer to say "income received." Though Mr. Justice Pitney leaves us somewhat uncertain as to just what he has in mind, the probability is that he means that the profits of the Central Pacific were in substance income received by the Southern Pacific when received by the Central Pacific.[40] If this is the Supreme

[38] Lynch *v.* Hornby and Peabody *v.* Eisner, note 4, *supra*.

[39] 247 U. S. 330, 334-335. Later at page 337 it is said:

"We base our conclusion in the present case upon the view that it was the purpose and intent of Congress, while taxing 'the entire net income arising or accruing from all sources' during each year commencing with the first day of March, 1913, to refrain from taxing that which, in mere form only, bore the appearance of income accruing after that date, while in truth and in substance it accrued before . . . "

[40] "That the dividends in question were paid out of a surplus that accrued to the Central Pacific prior to January 1, 1913, is undisputed; and we deem it to be equally clear that this surplus accrued to the Southern Pacific Company prior to that date, in every substantial sense pertinent to the present inquiry, and hence underwent nothing more than a change of form when the dividends were declared." (247

Court's idea, it follows that whenever two corporations are in substance identical, no transfer from one to the other can be income. Mr. Justice Pitney lends countenance to this inference,[41] but at the same time he warns us against it by saying that "the case turns on its very peculiar facts."[42] This warning leaves it open to the court to say that the case stands on a combination of the peculiar character of the dividend transaction and the peculiar interrelation of the corporations and not on the latter alone.

This opportunity is not foreclosed by anything in Mr. Justice Holmes's opinion in the *Gulf Oil* case. There is reference to the fact that the debts transferred from the subsidiaries to the holding company were "all enterprise debts due to members,"[43] and this is one of the circumstances which are said to "unite to convince us that the transaction should be regarded as bookkeeping rather than as 'dividends declared and paid in the ordinary course by a corporation.'"[44] Here, as in the *Southern Pacific* case, no checks were drawn. Entries on the books were all that was necessary to make the titular transfer. Thus neither case nor both combined can be said securely to establish that the complete identity of two corporations through ownership and management of one by the other prevents actual transfers from being taxable dividends. Nor do they establish that two corporations will be regarded as identical merely because one is completely owned by the other. The Southern Pacific Company ran the business of the Central Pacific, and the companies involved in the *Gulf Oil* case "constituted a single enterprise carried on by the petitioner."[45] Furthermore, it is to be

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U. S. 330, 335–336). The surplus that accrued to the Central Pacific came from earnings duly received and was therefore as to it realized income in the constitutional sense. The statement quoted above carries the thought that whatever happened to the Central Pacific happened contemporaneously to the Union Pacific since the two were one and the same.

[41] The quotation in note 39, *supra*, continues:

[We base our conclusion in the present case upon the view . . .]; "and upon the fact that the Central Pacific and the Southern Pacific were in substance identical because of the complete ownership and control which the latter possessed over the former, as stockholder and in other capacities. While the two companies were separate legal entities, yet in fact, and for all practical purposes, they were merged, the former being but a part of the latter, acting merely as its agent and subject in all things to its proper direction and control."

[42] 247 U. S. 330, 338.

[43] 248 U. S. 71, 72.

[44] *Ibid.*

[45] *Ibid.*

noted that both cases rest solely on the interpretation of the statute. They do not hold that such transfers as they involved could not be income under the Sixteenth Amendment. Substance prevailed over form where form was filmy and where Congress had not explicitly declared that form should control, but the victory was only in a minor skirmish and not in a major engagement.

This brings us to the second group of cases, in which three parties are involved. A stockholder receives from a corporation a dividend in the stock of another corporation. In the three cases to be considered the dividend-receiving stockholder has been an individual and not a corporation. This individual was but one of many stockholders, so that there was no room for the contention that he was in substance identical with the dividend-paying corporation. Had the recipient of the dividend been a corporation taxable on intercorporate dividends under the Act of 1913, there might have been two alleged identities to take into account and these two might have merged into one. In addition to the substantial identity of the dividend-paying and dividend-receiving corporations, as in the *Southern Pacific* case and the *Gulf Oil* case, there might have been alleged identity of the corporation paying the dividend and the corporation in whose stock the dividend was paid and it might have been urged that all three corporations were in substance one and the same. Such triplicate corporate unity will not present itself in disputes under the Sixteenth Amendment as to the taxability of dividends so long as intercorporate dividends continue to be exempt from the federal income tax. It may of course intrude in complaints against state income taxes under statutes which take toll from intercorporate dividends. We may, too, get an alleged three-headed calf as an exhibit for recognition as a single calf under the Sixteenth Amendment if we have a case in which the individual stockholder controls and manages both the corporation whose stock he receives and the corporation from which he receives it. No such case has yet appeared. The problem to date is restricted to complaints that the identity of the corporation paying the dividend and the corporation in whose stock it is paid makes the dividend in substance one in the stock of the paying corporation and therefore not taxable income under the *Stock Dividend Decision*.

This complaint was not made in *Peabody* v. *Eisner*,[46] in which the Union Pacific Railroad Company paid to its stockholders an extraordinary dividend in the stock of the Baltimore & Ohio Railroad Company. The relations between the Union Pacific and the Baltimore & Ohio are not mentioned. Apparently Mr. Peabody contended that a dividend in stock is a stock dividend whether the stock be that of the declaring corporation or of some other. This was curtly answered by saying that "the dividend of the Baltimore & Ohio shares was not a stock dividend but a distribution *in specie* of a portion of the assets of the Union Pacific, and is to be governed for all present purposes by the same rule applicable to the distribution of a like value of money."[47] The *Southern Pacific* case, on which the district court had relied to spare Mr. Peabody, was distinguished by Mr. Justice Pitney on the ground that it involved the substantial identity of the payer and the receiver of the dividend, whereas in the present case the receiver was an ordinary stockholder whose right was "merely to have the assets devoted to the proper business of the corporation and to receive from the current earnings or accumulated surplus such dividends as the directors in their discretion may declare; and without right or power on his part to control that discretion."[48] This of course looks at the stockholders one by one and not collectively, though all of them receive a dividend when dividends are declared and all of them collectively have ultimate power to control the corporation. In this, however, there is no more lack of substance than in any case in which a corporation and its stockholders are treated as distinct. Nevertheless it suggests that a keen scent for the substantial might not lose the trail across the formal gulf between the complete ownership and control of one corporation by another and the complete ownership and control of the second corporation by its collective stockholders.

The cases in which a stockholder adduced the substantial identity of the corporation from which he received a dividend and the corporation in whose stock the dividend was paid were decided on November 21, 1921. The facts of *United States* v. *Phellis*[49] have already been stated. A New Jersey corporation gave birth to

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[46] 247 U. S. 347 (1918).

[47] *Ibid.*, 349–350.

[48] *Ibid.*, 349.

[49] 257 U. S. —, 42 Sup. Ct. 63 (1921).

a Delaware corporation, to which it turned over its assets and its business and from which it received all the stock issued. The New Jersey corporation remained in existence as an empty shell, retaining enough of the Delaware stock to maintain its original capital unimpaired and to provide for its outstanding obligations, and turning the rest over to its stockholders to the extent of two shares of Delaware for each share of New Jersey held by them. In *Rockefeller* v. *United States* [50] some oil companies organized new corporations to which they turned over their pipe lines. Some of the stock in the pipe-line companies went directly to the stockholders of the oil companies, and some of it went to them through the oil companies by way of dividends. The two methods of distribution were held to be substantially similar[51] and the stock of the newly created pipe-line companies thus received by the stockholders of the oil companies was held to be income to its full value without inquiry into the actual gain to the stockholders on their original investment.

How Congress now analyzes the substantial nature of such corporate shifts and segmentations is apparent from the provision in the Income Tax Act of 1921 as to the swap of stock in one corporation for that in another made from its rib or taking its place. Formerly such a swap was treated as an income-producing transaction to the extent that the new stock brings to its recipient a gain on his capital investment.[52] Later a compromise provision recognized the new stock as in effect a continuation of the old to the extent that the par value of the new does not exceed the par value

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[50] 257 U. S. —, 42 Sup. Ct. 68 (1921).

[51] "Under the facts as recited we deem it to be too plain for dispute that in both cases the new pipe-line company shares were in substance and effect distributed by the oil company to its stockholders; as much so in the case of the Kansas company, where the new stock went directly from the pipe-line company to the stockholders of the oil company, as in the case of the Ohio company, where the new stock went from the pipe-line company to the oil company and by it was transferred to its stockholders. Looking to the substance of things the difference is unessential. In each case the consideration moved from the oil company in its corporate capacity; the new company's stock issued in exchange for it was distributed among the oil company's stockholders in their individual capacity, and was a substantial fruit of their ownership of stock in the oil company, in effect a dividend out of the accumulated surplus." (42 Sup. Ct. 68, 69.)

[52] See Robert H. Montgomery, "Reorganizations and the Closed Transaction," in THE FEDERAL INCOME TAX (Columbia University Press, 1921), at page 126.

of the old.[53] Such disregard of actual values yields absurd incongruities. These are now done away with by Section 202 (c) (2) of the Act of 1921, which declares that no gain or loss shall be recognized when in the reorganization of two or more corporations a person exchanges his old stock for new. Moreover reorganization is liberally defined.[54] Thus henceforth when there is a fair approach to identity between the old corporation and the new, the exchange of the old stock for the new is not deemed a realization of the actual gain that has accrued to the stockholder since his original investment. The new statute extends no such grace to dividends arising out of corporate reorganizations. It leaves us with the absurd incongruity of exempting exchanges no matter how much the holdings of the stockholder have enhanced in value since their acquisition and of taxing dividends even though no enhancement has accrued.[55] The constitutional power to deal thus rudely with reorganization dividends is affirmed in the *Phellis* and *Rockefeller* cases in which the reorganizations involved were even more formal than ones which Congress now overlooks in its section dealing with exchanges of new stock for old.

The decisions in these cases were by votes of seven to two and six to two. In the *Rockefeller* case Mr. Justice Clarke did not sit. In both cases Justices McReynolds and Van Devanter dissented and the former filed a brief opinion in the *Phellis* case which appears to go on constitutional grounds when it says that the prin-

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[53] *Ibid.*, pp. 126–131.

[54] "The word 'reorganization,' as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form or place of organization of a corporation (however effected); . . .

[55] Not only this, but it apparently seeks to prevent its kindness towards exchanges from being transferred to dividends by the device of issuing stock dividends and then exchanging stock so received for stock in a new corporation born of a reorganization. Thus Section 201 (d) of the Act of 1921 declares:

"A stock dividend shall not be subject to tax but if after the distribution of any such dividend the corporation proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend, the amount received in redemption or cancellation of the stock shall be treated as a taxable dividend to the extent of the earnings or profits accumulated by such corporation after February 28, 1913." But for this provision, in such situations as those involved in the Phellis case and

ciple of *Eisner* v. *Macomber*[56] seems in conflict with the decision announced. This is preceded by quotation from the opinion of the Court of Claims which calls the transaction merely a financial reorganization and remarks that it seems incredible that Congress intended to tax as income a transaction that produced no gain or profit. This ought not to be so incredible to any one familiar with the previous status of extraordinary dividends in cash or property. It is high time that judges and scholars all join in singing a *requiescat* over the foolish idea that a conversion of wealth from one form to another must be a creator of gain in order to yield income. Mr. Justice McReynolds would have done well to have refrained from devoting a third of his opinion to repetition of this folly and to have used the space thus saved to elaborate his reliance on the *Stock Dividend Decision* and to expound more fully his declared assumption that "the statute was not intended to put an embargo upon legitimate reorganizations when deemed essential for carrying on important enterprises." [57] Congress has certainly shown no inclination to refrain from taxing any and every dividend that transfers corporate gains accrued since March 1, 1913. When doubt arose as to whether it meant to tax stock dividends, it removed the doubt by an explicit affirmative declaration. *A fortiori* it must have desired to tax dividends in the stock of another corporation to the full extent that the Supreme Court would permit. It still fails to modify this intention notwithstanding its kindlier

the Rockefeller case, if the original corporations turn their surplus into capital and issue stock dividends and the stock thus received is then surrendered and the stock in the new corporations acquired, neither the stock dividend nor the subsequent exchange would yield taxable income. Possibly this provision might be construed not to apply to exchanges through reorganization. It may be argued that this method of change is not "redemption or cancellation" and with still more force it may be urged that the word "amount" indicates that Congress had in view a redemption for cash. If such arguments should prevail it would be because of judicial favor toward the result rather than because of any literary compulsion.

The constitutionality of the provision as applied to redemption for cash may be questioned. If the court thinks of the issue of the stock dividend as a dead and buried transaction that cannot be disinterred, it will hold that the cash received on redemption is income only to the extent that it brings a profit on the original investment in the corporation. It may, however, liken the enterprise to that of the Grand Old Duke of York and hold that the journey up the hill and down again is a little frolic that may be disregarded. The decision in the Stock Dividend Case was in terms confined to *bona fide* stock dividends.

[56] Note 33, *supra*.

[57] 42 Sup. Ct. 63, 68.

disposition towards profit from the exchange of stock in the course of a corporate reorganization. There can be no fair doubt that the only issue seriously before the court in the *Phellis* case and the *Rockefeller* case was one of constitutional law and not of statutory construction. This issue was whether or not the old and the new corporations were in substance one and the same so that the receipt of new stock for old is no more a realization of income within the requirement inferred from the Sixteenth Amendment than is the receipt of a dividend in the stock of the declaring corporation.

In meeting this issue Mr. Justice Pitney insists that the old and the new corporations are substantially separate and distinct. In the *Phellis* case he emphasizes the fact that the new corporation is organized in another state which, he says, necessarily imports a different measure of responsibility to the public and presumably different legal relations between the stockholders and between them and the corporation. He thinks it worth mentioning that the new corporation has an authorized capital four times that of the old, and he clinches the matter by saying that the very fact that the assets were transferred from the old corporation to the new evidences the actual separateness of the two. The identity of stockholders and of officers in the two companies is dismissed because not certain to continue.

There is more to the opinion, but when analyzed it is either mere assertion of the separateness of the two corporations or a description of the situation based on the assumption of such separateness. For example, it is said to be erroneous to test the question whether income has been derived by regarding alone the general effect of the reorganization on the aggregate body of stockholders, since the liability of the individual stockholder to pay an income tax depends on the effect of the transaction on him as an individual. The effect on the individual in the two cases is said to be that a part of the corporate surplus has become transferred from the corporation to him in such form that he may sell it and still retain his proportionate share of the old corporation. True enough, if the old and the new corporations are substantially distinct; false, under the *Stock Dividend Decision*, if the old and the new are substantially one and the same.

When in the *Rockefeller* case Mr. Justice Pitney says that the facts are in all essentials indistinguishable from those in the *Phellis*

case, he silently eliminates the importance there attached to the fact that the two corporations were organized in different states, since the oil companies organized their pipe-line companies in the same states to which they owed allegiance. In this case too the opinion assumes the point at issue when it says that the pipe-line stock represents assets of the oil companies capable of division among the stockholders as the assets themselves were not. If the pipe-line stock was in reality the same as newly created oil stock, all that was capable of division was a new evidence of an interest already possessed.

Further exposition of the opinions is unnecessary. The results speak for themselves. The issue was whether the dividend-paying corporations distributed in substance their own stock or the stock of a distinct corporation. The time of distribution was the time to determine whether the two corporations were in substance identical. At that time two of the old corporations owned all of the stock of two of the new. The other old corporation controlled the disposition of the stock of the new. The officers of one of the old corporations were the officers of one of the new. Continuing identity *vel non* of stockholders is beside the point. It took the distribution to create the initial identity. If the distribution was in substance in stock of the declaring corporation, it was in substance a stock dividend and so not duly realized income. As well might it have been said that the Southern Pacific and the Central Pacific were not in substance identical because the former might in the future part with some or all of its stock in the latter. They were identical then and that was enough. If it be said that their past identity was material, it may be said that the pipe-line companies came from the womb of the oil companies and that from birth until the time when their status ceased to be material they were completely subject to parental control.

It is worthy of note that Mr. Justice Pitney makes no attempt to distinguish the intercorporate relations in these two cases from those in the *Southern Pacific* case and in the *Gulf Oil* case. He refers to those two cases as evidence of the court's respect for substance and disregard of form, but this is all. The question arises: Would the court have held that a dividend paid by the Southern Pacific in the stock of the Central Pacific is a stock dividend rather than a dividend in stock? One suspects not. Would it have held

that a transfer from the Central Pacific to the Southern Pacific of cash or of a trolley line or of stock in still a third corporation was not income to the transferee? Here one is more doubtful. Such dividends could not be called mere bookkeeping transactions, as were those in the actual case and in the *Gulf Oil* case. Those cases could therefore be distinguished. Yet one suspects that the court might have recognized that intercorporate dividends of any kind are poor things to regard as income and so have held that any transfers between corporations substantially identical are to be treated as purely formal. The question will not arise for adjudication now that Congress leaves intercorporate dividends alone. In its wisdom it finds all such dividends purely formal, whether the corporations are identical or not.

No one with a spark of realism in his soul can doubt that the oil companies and the pipe-line companies, the New Jersey Dupont concern and the Delaware Dupont concern, were in all substance as completely one and the same as were the Southern Pacific and the Central Pacific, the Gulf Oil holding company and its subsidiaries. The fact that Mr. Justice Pitney does not venture on the perilous task of making any distinction is in itself significant. If the Supreme Court were ever to look through the corporate entity to extend the *Stock Dividend Decision* to dividends paid in the stock of a technically distinct corporation, it cannot justify its refusal to do so in the *Phellis* case and the *Rockefeller* case. It certainly would have held that the corporations in question were identical within the prohibitions of the Commodities Clause of the Hepburn Act.[58] It ventured no suggestion as to what was lacking to complete their identity. One sundering element stressed in one case was missing in the other and its absence was passed over in silence. The formal and unsubstantial recital and analysis in the opinions is pretty clear proof that form alone was regarded as sufficient to ward off the substantial implications of the *Stock Dividend Decision*. It is therefore difficult to resist the conviction that these most recent interpretations of the Sixteenth Amendment mean that Congress may always treat two corporations as separate and distinct for the purpose of taxing as income a dividend paid by one in the stock of the other.

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[58] See United States *v.* Lehigh Valley R. R. Co., 220 U. S. 257 (1911).

With such a decision standing alone there need be no quarrel except as it adds to the instances in which gains or profits are not requisite to income. It has long been part of our law that the courts will disregard the corporate entity only in exceptional cases, and these chiefly to prevent the corporate cloak from shielding wrong. It would be going far, therefore, to declare that the Constitution requires Congress to disregard the corporate entity in deciding whether income has been realized, when the requirement of realization itself is not specifically set forth in the Constitution. Stockholders who are taxed only on their actual gains have little ground of complaint against a decision that a formal alteration of the evidence of their capital is a sufficient realization of that gain. It may be unpleasant and even painful to have to pay a tax now, but in the long run it is easier to bear progressive rates on gains accruing during brief periods than to wait till the gains are so great that they mount to the highest brackets of the schedule. The hope that realization may be postponed forever is certainly not one to foster. If realization is bound to come, it is easier to have it come in driblets. The argument may not apply to Mr. Rockefeller with his sad prospect of the highest brackets for himself and his heirs forever, but it holds good for many of his more fortunate fellows. We may then commend a decision that dividends in stock of other corporations are dividends in property even though the two corporations involved are flesh of the same flesh.

The temptation to criticize assails us when this result has to be compared with others and we are asked to believe that the distinctions are distinctions of substance and not of form. The substance, if substance it be, is an arid, Pickwickian, legal sort of substance and not a common-sense, matter-of-fact, economic sort of substance. The mythical but discerning man on the street would be hard put to it to tell why Mr. Rockefeller's draught from the cruse is income when Mrs. Macomber's is not. He would be puzzled to know why the Gulf Oil Corporation and its satellites were one and the Standard Oil Company and its creature were two. He might when duly initiated into the mysteries perceive the distinctions of form which the cases recognize and establish; but when assured that they are distinctions in substance and in truth, he would ask Pilate's question in bewilderment and despair.

This is not to say that the applications of the distinctions are

without pragmatic merit. Take, first, the difference between a dividend paid by one corporation to another and a dividend paid to an individual by the second corporation in the stock of the first. If, as it seems, these two transactions will be treated differently even when the intercorporate relations are indistinguishable, there is wisdom in finding the intercorporate dividend mythical and the dividend to an individual authentic. We may well disregard the outpour from one reservoir to another and still heed the flow at the faucet. There is something to be said, too, for drawing the line between dividends in the stock of the declaring corporation and those in the stock of any other however closely associated with the first. The requisite of realization is in part wholesome and in part noxious. There are so many varying modes of altering the embodiment of one's wealth or profits that applications of the test of realization are necessarily somewhat arbitrary. If some favor the government and others favor the taxpayer, this appeals to a sense of fairness when the situation is such that practical considerations make it impossible to be fair and without favor in each individual case. The distinction between some formal payment from the corporate treasury and no payment therefrom is at least a workable one. Cases on opposite sides of the line will be alike in economic substance, but the line, however formal, is clear and straight so that corporate managers and stockholders are advised of the side on which their acts will fall.

So our criticism is not so much of what the judges have done as of what they have said and left unsaid by way of justification. The practical necessity of purely arbitrary distinctions is too seldom explicitly recognized. The practical wisdom of choosing one alternative rather than another is too seldom expounded. Consistency is professed when inconsistency is present and unavoidable. The situation often demands a series of compromises, and compromise is based on a balancing of opposing, not of concurring, considerations. The law knows a number of situations in which one suspects that courts seek to preserve a balance by leaning now to one side and now to the other. So it may well be in determining whether there has been an adequate realization of income. If the taxpayer is favored in respect to one type of dividend, why not favor the government in respect to another? Let one close deci-

sion go in favor of the home team and the next in favor of the visitors. Such considerations must influence judicial umpires as they influence others, but they introduce incongruities which are inconsistent with the conception of the law as a company of automatic universals that never encroach on each other's preserves. Therefore we have sophistical professions of the absence of incongruity bolstered up by recourse to artificiality. Instead of confessing that the artificialities are evoked to make desirable compromises without explicitly exposing the mythical assumption of perfect symmetry in the law, the judges too often exalt the artificialities as inherent substances that constrain them whether they will or not. Thus the substance of the law sometimes takes on the attributes of the substance of the schoolmen. Now and then this deters courts from reaching results that they know to be the best. Even when this is avoided the artificiality is not saved from sin. There still remains the reproach if not the contempt which the profane feel toward an institution whose votaries can revel in a realm of make-believe with such seriousness as to invite the comment that their art is that "of being methodically ignorant of what every one knows to be true."

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